IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-750

LIBERTY NATIONAL LIFE INSURANCE COMPANY,
Petitioner,
vs.
UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Procedural Rules

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Liberty National Life Insurance petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

I

OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Alabama is annexed hereto as Appendix A and is unofficially reported in 77-1 USTC ¶ 9107. The opinion of the United States Court of Appeals for the Fifth Circuit is annexed hereto as Appendix B and is reported at 600 F.2d 1106.

II

JURISDICTION

The judgment of the Court of Appeals was entered on August 13, 1979 and is annexed hereto as Appendix C. Timely application for rehearing by Petitioner was denied on September 20, 1979. Report of such denial is annexed hereto as Appendix D. The jurisdiction of this Court is invoked under 28 USC § 1254(1).

III

QUESTIONS PRESENTED FOR REVIEW

1. Where the Court of Appeals determines that taxpayer is entitled to some but not all of the refund awarded by the trial court in a tax refund case, is it "just under the circumstances" for the Court of Appeals to reverse without remanding the case to the trial court for redetermination of the amount of refund due?

2. Where the findings of the trial court sitting without a jury have a basis in the record taken as a whole, is it the "accepted and usual course of judicial proceedings" for the Court of Appeals to substitute its own view of the evidence for that of the trial court?

IV.

STATUTES INVOLVED

A. Appellate Jurisdiction

Appellate jurisdiction of the Court of Appeals is found in 28 USC § 2106 and reads:

> The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside or reverse any judgment, decree, or order of a court lawfully brought before it for review, and may remand the cause and direct the entry of such appropriate judgment, decree, or order, or require such further proceedings to be had as may be just under the circumstances.

B. Internal Revenue Code

The specific statute of the Internal Revenue Code involved is 26 USC 805(e)(3) reading as follows:

> Interest paid.—For purposes of this part, the interest paid for any taxable year is the sum of—
>
> * * * * * * *
>
> (3) Discount on prepaid premiums. All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity-contracts.

These statutes are also annexed as Appendix E herein.

V.

STATEMENT OF THE CASE

A. Statement of Proceedings

Petitioner Liberty National Life Insurance Company (Liberty National), is a life insurance company. For the years 1966 through 1969 it paid federal income taxes totaling $14,175,666.98, and brought an action in the district court pursuant to 28 USC § 1346(a)(1) for the refund of a portion of those taxes erroneously assessed and collected. After a trial of five days by the district court (Frank H. McFadden, Chief Judge) sitting without a jury, the district court found in favor of the taxpayer for the full amount of the refund claimed. The government appealed. The Court of Appeals reversed, even though:

> We recognize that some part of the discount may be attributable to interest. In fact, the government admitted this at trial. Thus, it could be argued that the portion of the discount that is in the nature of interest is properly deductible. (600 F.2d 1106, 1115)

Liberty National urged in its timely petition for rehearing that the Court of Appeals remand the proceedings to the district court for a determination of the amount of the refund which was due Liberty National. It urged that the Court of Appeals in substituting its view of the evidence for that of the trial court had failed to properly follow the "clearly erroneous" requisite of Rule 52. This petition was "denied."

B. Statement of Facts[1]

During the years in suit, Liberty National granted discounts to life insurance policyholders who paid their weekly premiums by as much as 26 weeks in advance of their due date. If the premiums were paid by as many as 26 weeks or more and less than 52 weeks in advance, the Company granted a discount of 5% of the total of such premiums paid. If the premiums were paid 52 weeks or more in advance of their due date, the discount granted was 10%. This practice of granting discounts for premiums paid in advance had its beginning with a predecessor company in the depression years of the 1930's. That small company issued burial insurance policies providing funeral benefits having a retail value of $300. Premiums on such policies were payable weekly in small amounts substantially less than a dollar a week. That company had financial difficulties. It needed funds to pay current operating expenses and to pay policy benefits. To obtain these funds it offered discounts to premium payers as an inducement. Instruction books given to its agents informed of the practice as follows:

[1] The operative facts are fairly set forth in the district court opinion.

> A discount of 10% will be allowed on premiums paid for 52 or more advance weeks.
>
> A discount of 5% will be allowed on all premiums paid for 26 advance weeks.

This practice became well known and collection campaigns were actively promoted to induce premium payers to pay their premiums in advance of their due date. Because the weekly premiums were small, the discount had to be of such magnitude as to offer some inducement. The discounts were stated simply as a percentage of the premiums. Though the effective rate of interest was not considered at the time the amounts of the discounts were determined, a 10% discount amounted to an effective annual interest rate of 24% for premiums paid 52 weeks in advance and a rate of 7.5% annually for premiums paid 156 weeks in advance. The effective rate of interest would, of course, vary with the number of weekly premiums paid in advance.

The company weathered the depression, established itself, and began issuing weekly premium life insurance policies payable in cash. The face amounts of these policies were less than $1,000. Premiums were payable weekly. The granting of discounts for premiums paid in advance of their due date continued.

In 1944 the company was merged into Liberty National. Liberty National continued to grant the discounts not only for policies issued by the predecessor company, which were in force, but also for the industrial life insurance policies that it continued to issue after the merger. It was characteristic of the life insurance policies upon which the discounts were granted that the face amounts were $1,000 or less, that the small premiums were payable weekly, and that an agent of the company called at the homes of the policyholders to collect the premiums.

For each of the four tax years in question (1966, 1967, 1968 and 1969) the total of the discounts granted by Liberty National was between $400,000 and $500,000. In its federal income tax returns for the calendar years 1966 and 1967, Liberty National, as it had in all years in which it filed a return under the Life Insurance Income Tax Act of 1959, claimed 60% of the total discount as being in the "nature of interest" within the meaning of IRC Section 805(e)(3).

Some two or three years after these returns were filed, they were audited by the Service and a written report was completed in November, 1969. This report (Stipulation Exhibit 5, pp. 17, 18, 19, 27 and 28) stated,

> . . . the discounts allowed for advance premium payments . . . was allowable as interest or an item in the nature of interest for 100% of the discount.

Thus, on audit of Liberty National's returns for the years 1966 and 1967, the Service, on its own initiative, determined that Liberty National was entitled to deduct *all* of the discount given rather than a portion (60%) thereof as Liberty National had claimed in filing its returns.

After this, Liberty National filed its tax returns for the calendar years 1968 and 1969 and claimed the entire amount of the discount as being "in the nature of interest," in keeping with the findings of the Revenue Agent. After all of these returns were filed, a second audit was made by the Service and this audit was conducted by a different Revenue Agent. This Agent, in his supplemental report in October, 1971, disagreed with the first Agent and disallowed *any* deduction of this discount by Liberty National as being in the "nature of interest."

A deficiency assessment was then made by the government based upon the contention of the second audit that none of the discount should have been allowed as being in the "nature of interest." Liberty National paid the amount of the deficiency and

filed a claim for refund. After denial of the claim for refund, this suit was brought in the district court for a refund contending that the entire amount of the discount was in the nature of interest.

After a five-day trial the court, sitting without a jury, found in favor of the taxpayer and held that the entire amount of the discount granted for premiums paid in advance was deductible as "discounts in the nature of interest" under IRC § 805(e)(3). The government appealed. The Fifth Circuit reversed, although recognizing (as the government admitted) that a portion of the discount was in the nature of interest. However, rather than remanding the case for further proceedings in the district court to determine the portion of the discount which was in the nature of interest and therefore deductible, the Fifth Circuit simply reversed. It denied a petition for rehearing to remand for this determination.

The district court in its memorandum opinion concluded that Liberty National was entitled to recover the taxes erroneously assessed and directed the parties to "compute the proper amount of the judgment to be entered and submit the computation to the Court within 60 days for the entry of proper judgment in accordance with this Memorandum Opinion." Pursuant to this direction the parties did submit to the court the amount of the judgment to be entered which included the entire amount of refund claimed.

Thus, in the proceedings in the district court Liberty National proved not only that the assessment of additional income tax by the government was erroneous, but it also proved the amount of the refund which it claimed and received judgment therefor. Upon appeal, the Fifth Circuit simply "reversed" although recognizing that at least a portion of the refund should be granted. Because the court refused to remand for that portion to be determined, this petition is filed.

VI

REASONS FOR GRANTING THE WRIT

A

The Statutory Jurisdiction (28 USC 2106) of the Court of Appeals Requires It to Render Such Relief As Is "Just Under the Circumstances." The Reversal By the Court of Appeals of Judgment in Favor of Taxpayer Granted By the District Court Without Remanding to the District Court For Determination of the Amount of the Refund Admittedly Due Taxpayer So Far Departed From the "Accepted and Usual Course of Judicial Proceedings" (Rule 19 of the Supreme Court of the United States) As to Require the Exercise of This Court's Power of Supervision.

In initially preparing and computing its federal income tax returns for the years in suit, Liberty National claimed only a portion of the discounts granted for premiums paid in advance of their due date as being in the "nature of interest" and, therefore, deductible under § 805(e)(3) of the Internal Revenue Code. Upon audit, the Internal Revenue Service initially determined that the *entire* amount of the discount should have been deducted. Upon reaudit by another agent, the Internal Revenue Service determined that *none* of the discount should have been deducted as being in the nature of interest. Assessment by deficiency was made on the basis of the second audit. Liberty National paid the assessment and sued for refund. After trial the district court found in favor of Liberty National—that the entire amount of the discount was deductible as being in the "nature of interest." The Court of Appeals held the trial court erred in granting the entire refund, but indicated that taxpayer was entitled to a portion of the refund claimed. Rather than to remand the suit to the trial court for a determination of this portion, the Court of Appeals simply reversed and in doing so unjustly denied to Liberty National the right to prove, in accordance with the Fifth Circuit's stated views, the portion of the discount which it was entitled to deduct, and, therefore, the portion of the erroneous payment of taxes that it was entitled to recover.

Liberty National, in its petition for rehearing, urged the Court of Appeals to remand the proceedings to permit this determination to be made so that the statutory standard of review would be met and the court would render relief that would "be just under the circumstances." See 28 USC 2106. This petition was denied. Petitioner suggests that this action of the Court of Appeals, "so far departed from the accepted and usual course of judicial proceedings, . . . as to call for an exercise of this court's power of supervision." See Rule 19 of the Supreme Court of the United States.

The teaching of the oft-cited decision of this Court in *Helvering* v. *Taylor,* 293 U.S. 507, 515; 55 S.Ct. 287, 291; 79 L.Ed. 623 (1935) is that:

> . . . it may not reasonably be held that [taxpayer] is bound to pay a tax that confessedly he does not owe . . .

When such situation arises, the suit should be remanded for further proceedings. See *R. M. Smith, Inc.* v. *Commissioner* (3 Cir. 1979) 591 F.2d 248, 251. That remand would be the "accepted and usual course" is reflected in decisions of the various Circuits. In *Kurlan* v. *Commissioner* (2 Cir. 1965) 343 F.2d 625, 629, at footnote 3, the court said:

> . . . it would seem unreasonable to require a taxpayer who insists he is entitled to treat the whole of a transaction as a capital gain also to come forward with evidence as to what portion should be so treated if the . . . reviewing court should reject his maxiumum claim but nevertheless consider that the deficiency determined by the Commissioner was excessive. Decisions remanding for allocation appear to support that view.

In circumstances similar to the instant suit, taxpayer in *Tunnell* v. *United States* (3 Cir. 1975) 512 F.2d 1192, recovered in the trial court the full amount of refund claimed. On appeal, the reviewing court recognized that there should be some refund but that it should be less than the entire amount claimed and awarded in the trial court. In remanding for further proceedings, the court said:

> We believe that, under the circumstances of this case, justice requires that we remand to the district court so that taxpayers may have the opportunity to prove the amount on which depreciation properly may be recovered. (page 1195)

Even if a tax refund suit is lost in the trial court, the appellate court, if it finds that taxpayer is entitled to some recovery, may remand for further proceedings. In *DeMink* v. *United States* (9 Cir. 1971) 448 F.2d 867, 869, the court said:

> . . . once we have determined the trial judge may have been in error . . . , the taxpayer is entitled to attempt to prove there should be an allocation . . .

The Fourth Circuit found there to be a well-established rule that an appellate court has the power to remand if the action has been tried on a wrong theory or if the record is not in condition for the appellate court "to decide the question presented with justice to all parties concerned." *Underwood* v. *Commissioner* (4 Cir. 1932) 56 F.2d 67, 73.

The Fifth Circuit has followed this practice in tax cases. In *M. M. Landy, Inc.* v. *Nicholas* (5 Cir. 1955) 221 F.2d 932 at 932 it said, ". . . we consider this to be a case in which we should remand for further proceedings, so that these essential facts may be established if they exist." In *Carloate Industries, Inc.* v. *United States* (5 Cir. 1966) 354 F.2d 814, the court reversed and remanded so that the trial court might ascertain the "extent" of a casualty loss for tax purposes. In *Southwestern Life Insurance*

Company v. *United States* (5 Cir. 1977) 560 F.2d 627 where the trial court erred in determining reserves to be set aside under accident and health policies, the court said, "This issue must be remanded" to determine "whether" and "to what extent" the setting aside of the reserves for these policies benefitted taxpayers in the several computations it must make in determining its income tax liability. Earlier in *Bisbee-Baldwin Corp.* v. *Tomlinson* (5 Cir. 1963) 320 F.2d 929 in a tax case involving the question of whether the sale of a mortgage servicing business should be treated as a capital transaction or as an ordinary gain transaction, the court affirmed in part and reversed in part, and remanded to the district court to determine the portion that should be treated as capital gain and the portion that should be treated as ordinary income. Recognizing (at page 935),

> In such instances, where part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded, [citing cases]. If it be said that to remand for this purpose is asking the [court] to separate the inseparable, we answer that no one expects scientific exactness . . .

It has been said that the power to grant a new trial to all or any of the parties on all or part of the issues inheres in appellate courts under the authority of 28 U.S.C. 2106, *Camalier etc.* v. *Madison Hotel, Inc.* (1975) 168 App. D. C. 149, 513 F.2d 407. Courts of appeal have used the authority to remand granted by 28 U.S.C. 2106 in various ways to assure such further proceedings as may be "just under the circumstances." See *Thompson* v. *Camp* (6 Cir. 1948) 167 F.2d 733 cert. den. 335 U.S. 824, 69 S.Ct., 48, 93 L.Ed. 378, and the "controlled remand" used to reflect the sweeping jurisdiction in *United States* v. *LePatourel* (8 Cir. 1978) 571 F.2d 405. In *McClure* v. *O.Henry Tent and Awning Co., Inc.* (7 Cir. 1951) 192 F.2d 904 remand was granted for purpose of finding a "specific fact." In *Atlantic C.L.R. Co.* v. *Bennett* (4 Cir. 1958) 251 F.2d 934, the court of appeals in reversing gave plaintiff the option of whether a new

trial should be granted on all issues or whether the plaintiff would accept a general damage award. In *Rosa* v. *City of Chester* (3 Cir. 1960) 278 F.2d 876 it was held that the provisions of 28 U.S.C. 2106 authorize the courts of appeal to grant new trial on limited questions rather than on all issues.

It would seem that the "accepted and usual practice" is for the federal appellate courts to "require such further proceedings to be had as may be just under the circumstances." The trial court in ruling for Liberty National for the entire refund claimed found that the government conceded that an interest factor was present. The Court of Appeals wrote:

> We recognize that some part of the discount may be attributable to interest. In fact, the government admitted this at trial. Thus, it could be argued that the portion of the discount that is in the nature of interest is properly deductible. (page 1115)

The government's expert witness testified that a portion of the discount was interest.[2]

When the taxpayer, the government, the trial court and the appellate court recognize that all or a part of the discount is in the "nature of interest" within the meaning of Section 805(e)(3), it would appear to be "just under the circumstances" that Liberty National be afforded the opportunity to establish to the satisfaction of the trial court by the introduction of additional evidence that portion of the discount which is in the nature of interest. It is requested, therefore, that this Court exercise its power of supervision and direct the Court of Appeals for the Fifth Circuit to give Liberty National this just right.[3]

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[2]Witness Barnhart, a consulting actuary, testified (R-4, 451-452), "Now, the primary element that is present here other than interest—there is certainly an element of interest I don't think I would contest that at all because you are receiving a payment now that you otherwise would receive in installments over an extended period of time."

B

The Court of Appeals Substituted Its Opinion of the Evidence For the Supported Findings of the District Court and So Far Departed From the "Accepted and Usual Course of Judicial Proceedings" In Applying the "Clearly Erroneous" Requisite of Rule 52 As to Call Forth the Exercise of This Court's Power of Supervision.

The essential finding of the Court of Appeals in the instant suit is:

> This testimony, combined with the other evidence we discussed above, indicates that the district court was clearly erroneous in concluding that taxpayer *intended* the discount as payment *for* the use of money. Therefore, the court's holding that taxpayer properly deducted the *entire amount* of the discount as interest paid must be reversed. (Emphasis ours). (600 F2d 1106, 1115).

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[3]Remand to the district court would not only provide petitioner with an opportunity to establish the amount of the refund to which it is entitled, but could also result in conserving time of the judiciary. Other income tax issues were tried and decided by the trial court and were briefed and argued in the appeal. They were not addressed by the Court of Appeals since they were asserted by the government as offsets to the amount of the refund claimed. All of these issues, however, including the one involved in the claim for refund and those involved in the offsets, are involved in computing the income tax liability of taxpayer for all years subsequent to those in issue. If the offset issues could be held by the Fifth Circuit and only the refund issue remanded for trial, the time and expense of the lawyers, the taxpayer, the witnesses, and the courts could be conserved. In other words, if the further proceedings could be limited only to the "discount in the nature of interest" issue and the present record used to rule upon the other issues in litigation, there would be more efficient use of the judicial machinery.

In substituting its view of the evidence for that of the district court, the Court of Appeals erred in finding that the "true reason for granting the discount" was "entirely apart from the desire to obtain the early use" of money. Witnesses Graves and Livingston, whose testimony is relied upon by the Court of Appeals to sustain its finding, testified contrary to these findings. They testified that the Company was willing to *continue* to pay the price of the discount for the early use of money. Mr. Graves said (R-1, 61), "The company gave the discount to have the use of the money." He said (R-1, 78-80) "the reason the Company gave the discount was to have 'the use of money ahead of time.' " Mr. Livingston said (R-3, 247-248) "this discount was the rent we gave that policyholder for the privilege of using his premiums in advance of their due date so here is a discount on the premium paid in advance. We gave it as rent on that money to get the premiums in advance of their due date . . .". The Company granted the discount for the early use of the money. The error of the Court of Appeals was to go afield as to "why" the Company continued to pay this discount for the early use of the money. Under the "clearly erroneous" requisite of Rule 52 FRCP, the Court of Appeals is not permitted to substitute its view of the evidence for that of the district court.

The evidence was that Liberty National was willing to *continue* to pay the high price for the early use of the money. It is true that Liberty National did not *need* to pay this higher price and continue this practice for the reasons given. The reason why the Company was willing to pay the higher price is not the issue. The issue is whether or not the Company paid that price. In addition to Graves and Livingston, officers of Liberty National, an independent certified public accountant whom the trial court characterized as having "many years experience in life insurance company taxation," testified that, "I believe the amounts have been properly deducted as discount in the nature of interest as interest paid." (R-3, 313). An independent actuary, the author of a recognized treatise on life insurance company accounting, testified:

> So my major conclusion has been this is interest, this is a discount in the nature of interest because the policy so provides and the company practice so continues and from an actuarial standpoint there is not any savings, not mortality or expense. (R-4, 362).

The Court of Appeals (footnote 6 page 1111) held that the "underlying issue why taxpayer granted the discount is factual and subject to the clearly erroneous rule on review." However, Rule 52(a) commits to the trial court the important and frequently decisive role of fact finding and such role may not be transferred to the Court of Appeals. It is erroneous for the Court of Appeals to assume this role. It is perhaps not necessary to quote from this Court's opinion in *United States* v. *Yellow Cab Co.* (1949) 338 U.S. 338, 342, 70 S. Ct. 177, 179, 94 L.Ed. 150

> . . . a choice between two permissible views of the weight of evidence is not 'clearly erroneous'.

Since the holding of the Court of Appeals is expressly that the "district court was *clearly erroneous* in concluding that taxpayer *intended* the discount as payment for the use of money," (emphasis ours) it seems appropriate to again observe this admonition in the *Yellow Cab* case (338 U.S. 338, 341):

> Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them.

This Court said in *United States* v. *National Association of Real Estate Boards* (1950) 339 U.S. 485, 495, 70 S. Ct. 711, 717, 94 L.Ed. 1007:

> It is not enough that we might give the facts another construction, resolve the ambiguities differently, and find a more sinister cast to actions which the District Court apparently deemed innocent [Citations]. We are not given

> those choices, because our mandate is not to set aside findings of fact 'unless clearly erroneous'.

Finally, in *Zenith Radio Corp* v. *Hazeltine Research Inc.* (1969) 395 U. S. 100, 123, 89 S. Ct. 1562, 1576, 23 L.Ed. 2d 129 this Court made a particularly appropriate comment:

> In applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues *de novo*. The authority of an appellate court, when reviewing the findings of a judge as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence.

A review of the evidence indicates that the Court of Appeals in these proceedings has failed to observe the role of the district court as the trier of the facts, and has departed from its appointed role, and, in fact, has so far departed from the "accepted and usual" application of the "clearly erroneous" rule as to call forth this Court's power of supervision.

VII

CONCLUSION AND PRAYER FOR WRIT

In a tax refund case where the district court found that the taxpayer was entitled to the full amount of refund sued for and the Court of Appeals finds that taxpayer is entitled to some part but not all of the refund, the Court of Appeals should remand the case for further proceedings so that the taxpayer may attempt to prove the amount of refund to which it is entitled. This is and should be the "usual and accepted" course of judicial proceedings. The Court of Appeals in the instant suit erred in its failure to remand.

A Court of Appeals is not the trier of fact. It is not to try the issues *de novo*. Findings of fact of the district court sitting without a jury should not be set aside unless clearly erroneous. In the instant suit, the Court of Appeals for the Fifth Circuit failed to observe these requisites. In such failure, it so far departed from the "usual and accepted course of judicial proceedings" as to call forth this Court's corrective supervision.

Petitioner respectfully prays that this Court issue its writ to the Court of Appeals for the Fifth Circuit to review its opinion and judgment.

Respectfully submitted,

Ralph B. Tate

Ira L. Burleson

Theron A. Guthrie, Jr.
ATTORNEYS FOR PETITIONER

Certificate of Service

Pursuant to Supreme Court Rule 33, I hereby certify that all parties required to be served have been served as follows: three copies of this Petition have been air mailed to the Solicitor General, Department of Justice, Washington, D. C. 20530, and three copies have been air mailed to Mr. M. Carr Ferguson, Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C. 20530 on this ____ day of ______, 1979.

Attorney for Petitioner

APPENDIX

APPENDIX A

In the United States District Court for the Northern District of Alabama, Southern Division

Liberty National Life
Insurance Company,

Plaintiff

v. Civil Action No. 73-M-1035

United States of America,

Defendant

MEMORANDUM OPINION

(Filed November 17, 1976)

Plaintiff seeks recovery of income tax deficiencies of $571,654.36 paid under protest. Refund claims were timely filed and denied. The Court has jurisdiction, venue is proper, and the suit is timely.

Four primary issues and two subsidiary ones are presented:

1. Were certain discounts for advance payments of weekly insurance premiums properly deducted as "discounts in the nature of interest" within the meaning of Section 805(e)(3) of the Internal Revenue Code?

2. Was plaintiff's deduction for contributions to its Profit Sharing and Retirement Plan (PS&R) properly allocated between investment and underwriting expense?

3. Were additional payments to plaintiff's PS&R Plan paid subsequent to the due date for contributions deductible as "interest paid" within the meaning of Internal Revenue Code § 805 (e) (1)?

4. Were plaintiff's general advertising expenses during those years properly allocated between investment and underwriting expense?

The latter three issues were raised as offsets by the Government and were first asserted in its amended answer to the complaint. These claims standing alone are barred by the statute of limitations, but may be raised as offsetting adjustments. *Lewis* v. *Reynolds,* 284 U.S. 281, 52 S. Ct. 145, 76 L. Ed. 293 (1932).

The two subsidiary issues are an offset claimed by the Government relating to the proper allocation of payroll taxes between investment and insurance expenses, and a claimed limitation on the amount of refund to which Liberty National may be entitled for the year 1966. Plaintiff concedes the payroll tax issue and contests the refund limitation issue.

Issue No. 1—Premium Discounts

During the years in suit, plaintiff granted discounts for payment of weekly life insurance premiums in advance by as much as 26 weeks. Advance payments of at least 26 weeks but less than 52 weeks were discounted 5%; advance payments of 52 weeks or more were discounted 10% of the total.

Plaintiff claims deductions as "interest paid":

YEAR	AMOUNT OF DISCOUNT
1966	$465,017.00
1967	448,054.00
1968	433,826.36
1969	454,531.98

Brown-Service Insurance Company, a predecessor to plaintiff, commenced this discount practice. This small company initially wrote only small burial policies with weekly premiums of less than $1.00. An acute shortage of funds caused it to urge advance premium payments and to offer the 52-week 10 percent and 26-week 5 per cent discounts. In light of the small premiums the discount had to be fairly large to offer some inducement, and no attempt was made to establish or state the discount as an

effective interest rate, which amounted to 24 per cent for the 52-week 10 per cent discount and 7.5 per cent for the 26-week 5 per cent discount. This discount policy was later applied by Brown-Service to small industrial life insurance policies.

Prior to 1944 when it merged with Brown-Service, Liberty National had also issued small, weekly premium, industrial life insurance policies, but had no advance premium discount policy. The merger resulted in a combination of the two agency forces and a uniform operation system which included advance premium discounts, expressly recognized from 1944 until 1967 by a policy provision. This provision was removed from policies issued after 1967, but the discount practice has continued to the present.

Premiums were computed and quoted on the basis of weekly payments, payable each Monday. Premiums are collected personally by debit agents who also provide policy services, whether or not premiums are paid in advance. For accounting purposes, premium collections are divided into two categories: Debit A (no discount), and Debit B (discount).

The taxpayer contends that these discounts are in the nature of interest deductible under 26 U.S.C. § 805(e)(3). The Government, while conceding that an interest factor is present, contends that it is in fact a different mode of payment which is economically justified on other grounds, principally greater profitability due to increased persistency and therefore is due to be disallowed as not being in the nature of interest.

Three primary factors enter premium rate computation: mortalilty, interest, and expense. The morality factor is the probability that the policy will mature as a death claim in each policy year; the interest factor is the estimated earnings from investment of premiums; the expense factor is the portion of premiums, and earnings therefrom, needed to pay the expense of operating the company. While it is customary to build profit into the expense factor, profit can be taken into account by conservative mortality and interest assumptions.

Advance premium payment had no bearing on an insured's death, and consequently did not affect the mortality factor. Existing advance premium payments upon maturity and upon surrender for cash value were refunded.

The expense factor was also unaffected by the discount. One of the large expenses of plaintiff was agents' compensation. It is without dispute that agents' compensation was based on the assumption that all premiums were paid on their due date and no reduction was made because of advance premium payments. It is also uncontradicted that there were no expense savings in plaintiff's district or home office operations. Rather, there was an expense increase for additional personnel required to handle the extra accounting required for the Debit B collections.

Interest, the cost of the use of money, was obviously affected by advance premium payments. Plaintiff had earlier money use with either increased investment earnings or reduced interest expense. Accordingly, the only premium computation factor affected by the discount was the interest factor. The discount granted for advance premium payment was in fact the price paid for the early use of money.

The fact that the discount was stated as a percentage of the total premiums rather than as an effective rate of interest is not determinative of whether the discount was in the nature of interest. The fact that the effective rate of interest might be as high as 24 per cent per annum does not change the basic nature of the discount.

The annual statements plaintiff filed with insurance supervisory officials of each state in which it was licensed reflected these advance premiums net of discount, in accordance with statutory accounting requirements and instructions of the National Association of Insurance Commissioners (NAIC). Periodic triennial zone examinations of the Company by State supervisory officials during these years pursuant to instructions of the NAIC, resulted in no criticism of or directed changes in

the method of accounting for advance weekly premium collections. Examination reports charactertized these payments as "true" advance premiums. This method of accounting for advance premiums is recognized as usual and customary in Section 125.9 of the Audit Technique Guidelines of the Internal Revenue Manual.

Conceding that there is an interest element in the discount the Government contends that it is insufficient to justify the manitude allowed. The Government's principal contention is that the discount has an economic basis totally unrelated to the use of money as such. It is contended that policies with advance premium payments have a better persistency which is sufficient economic justification for the discount. It is contended therefore that no part is allowable as a discount in the nature of interest. The Government argues that it is a different mode of payment economically justified just as surcharges on ordinary life policies are made for the increased cost of more frequent payments (i.e., monthly or quarterly instead of annually). This ignores the historical development of the discounts. Persistency did not enter into the matter. Historically, the discount was the price the Company paid for the right to use the money—the classic definition of interest. While the effective rate was high, it was that the Company was willing to pay in the beginning and once the practice was established, there was no effective alternative to continuation at that rate, if at all, because of the small premiums. One cannot, a quarter of a century later, say that what was clearly done for specific reasons really was done for different reasons. The Company needed the money and paid dearly to get it and then had to continue the practice for business reasons. It was interest then; it is interest now.

There was testimony that policies on which premiums were paid in advance may have had improved persistency resulting in substantial savings. This testimony was of very doubtful relevance but even so it failed to establish that the advance payments caused the better persistency. No evidence was presented measuring

the amount of improvement in persistency or establishing that it in fact resulted from the granting of the discounts. Government studies indicated that in one particular instance improved persistency resulted in increased profits, as might be expected, but again failed to measure the portion, if any, of such increased profits resulting directly from the granting of the discounts or that the underlying persistency improvement was attributable to the granting of discounts. The asserted monetary effect of the discount on either persistency or profitability was at best, and charitably speaking, speculative. The Court is unpersuaded by the evidence that the economic benefits of increased persistency were caused by the discounts and is of the view that the evidence on this issue was totally insufficient to establish the contention. The testimony at the time it was given, and on review, lacked credibility. The witness' testimony was admittedly based on incorrect assumptions and could not withstand analysis upon cross-examination. It seemed to the Court to be an effort to find an after-the-fact justification for disallowance and in the Court's opinion is without merit. Even if the discounts did improve persistency and generate savings, the evidence is clear that this was not the reason for granting them. The discount was granted to get money earlier. The price paid for that privilege was and is interest.

The Court, therefore, is of the opinion that the discount was a discount in the nature of interest.

The Life Insurance Company Income Tax Act of 1959 (PL 86-89, 73 Stat. 112, 26 U.S.C.A. §§801-820), a comprehensive revision of the tax law applicable to life insurance companies, places a tax upon taxable investment income and upon one-half the amount by which total gain from operations exceeds taxable investment income. It provides a three-phase procedure. Phase one tax base is the investment income less expenses and deductions. Phase two taxes a portion of the gain from operations. Phase three imposes a tax on certain deferred underwriting gains made available to shareholders upon which the tax was

deferred in phase two. *United States* v. *Atlas Life Insurance Company,* 381 U.S. 233, 85 S. Ct. 1379, 14 L. Ed. 2d 358 (1965).

From 1921 until 1958 life insurance companies were taxed only on their net investment income, very similar to the tax under phase one of the Life Insurance Company Income Tax Act of 1959. this Act permitted deduction for ". . .interest paid on indebtedness." Attempts to deduct discounts for advance premiums under this Act were not successful. *Illinois Life Insurance Company* v. *Commissioner* (1934), 30 B.T.A. 1160, *reversed on other grounds,* 299 U.S. 88, 57 S. Ct. 63, 81 L. Ed. 56 (1936); *Monarch Life Insurance Company* v. *Commissioner* (1938), 38 B.T.A. 716, *affirmed* 114 F.2d 314 (C.A. 1, 1940). In the latter case, the Board of Tax Appeals stated (38 B.T.A.727):

> . . . Discount allowed by petitioner for prepayment of premiums does not constitute *interest paid on its indebtedness* within the meaning of the statute, and is not an allowable deduction. [Emphasis supplied]

The Court of Appeals' affirming opinion stated:

> . . . Interest is the amount one has contracted to pay for the use of borrowed money. Deputy v. du Pont, 1940, 308 U.S. 488, 497, 60 S. Ct. 363, 84 L. Ed. 416. The money paid in advance by an insured to the company is not borrowed money. No indebtedness arises on the part of the company on the receipt of the money. The discount allowed is not payment for the use of borrowed money. The discounted sum received is the present value of the future amount due. The amount of the discount is the amount the company expects to earn by the use of the money before the regular due date of the premium. This amount added to the discounted value is expected to equal the amount payable on the due date had the premium not been paid in advance. This is in no sense interest on an indebtedness.

114 F.2d 314, 326 (C.A. 1, 1940).

Equitable Life Assurance Society used a different and successful method. It accepted funds from policyholders, agreed to hold such funds on demand, to supplement them with interest at a specified rate, and to apply the funds with the interest supplement in payment of premiums as they became due. Equitable successfully deducted these interest supplements as "interest paid on indebtedness," under the same statutory provisions relied on by Illinois Life and Monarch Life. The distinction in the two situations was pointed out in *Equitable Life Assurance Society of the United States* v, *commissioner* (1941), 44 B.T.A. 293, 310, *modified and affirmed on other grounds in* 137 F.2d 623 (2nd Cir., 1943), *aff'd* 321 U.S. 560, 64 S. Ct. 722, 88 L. Ed. 927 (1944):

> . . . In support of their position the respondent cites *Illinois Life Insurance Co.,* 30 B.T.A. 1160, in which we held that, where a life insurance company accepted the payment of premiums in advance and granted a discount on the payment, the amount of the discount did not constitute the payment of interest upon indebtedness. This was for the reason that the insurance company was not indebted to the policyholder for anything. Those are not the facts here. The petitioner owed the policyholder interest upon a deposit of money made by him. . . .

Under these decisions a life insurance company could deduct accrued interest under a premium discount plan but could not deduct discounts on advance premiums notwithstanding the fact that the economic realities of the two were the same. Congress' apparent recognition of this anomaly added Section 805(e)(3) of the Internal Revenue Code, recognizing the similarity of the two practices and according them similar treatment. Section 805(e)(3) permits deductions of discounts in the nature of interest in the following language:

> Discount on prepaid premiums.—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

It seems apparent that the intent of Congress was to permit life insurance companies to deduct discounts on prepaid premiums just as prior law had permitted a deduction for interest paid on premium deposit funds.

Senate Report 291, 86th Congress, First Session 1959 (2 U.S. Code Congressional and Administrative News, page 1626), states:

> . . . Paragraph (3) [Section 805(e)(3)], for which there is no corresponding provision in existing law, includes within the definition of "interest paid" all amounts accrued for the taxable year for discounts in the nature of interest (whether or not guaranteed) on premiums or other consideration paid in advance on insurance and annuity contracts.

It is stated in Denney and Rua, Federal Income Taxation of Insurance Companies, The Ronald Press, New York, 1961, at page 5.29, that:

> Provision for allowing the inclusion of discount on prepaid premiums as interest paid was first made by the Life Insurance Company Income Tax Act of 1959. Prior to that time it had been held [Monarch Life Ins. Co., 38 B.T.A. 716(A), aff'd 114 F. (2d) 314] that such discount was not 'interest paid on indebtedness' and consequently not deductible under prior law. Discounts in the nature of interest, whether or not guaranteed, on premiums and other considerations paid in advance on insurance or annuity contracts are now specifically includible.

The Regulations explain in Section 1.805-8(b(3) that the term "interest paid" includes:

(3) All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts. Such accrual shall be determined in accordance with the rules prescribed in section 818(b) and the regulations thereunder. For example, if at the beginning of the taxable year 1958 a life insurance company granted a discount in the nature of interest of $40 as the result of the prepayment of life insurance premiums for 5 years, the company may, under the straight-line method, accrue $8 in 1958 and each of the four succeeding taxable years ($40 [illegible] $8) and include this $8 as interest paid for each such taxable year.

The discount in this example is not stated as an effective rate of interest, which would have been different for each year, but only in a dollar amount, and is included within the term of "interest paid." This is quite similar in concept to plaintiff's use of straight percentages without reference to effective rates of interest.

Although there may be some valid distinctions between interest and discounts, for tax purposes these distinctions are of little significance. *Dixon* v. *United States,* 224 F. Supp. 358, 364 (D.C. N.Y., 1963). Interest is "compensation for the use of money." *Belcher* v. *Birmingham Trust National Bank,* 348 F. Supp. 61, 113 (N.D. Ala., 1968); *Daniel* v. *First National Bank of Birmingham,* 228 F.2d 803 (5th Cir. 1956). The discount granted for payment of premiums in advance on individual life insurance and annuity contracts represents interest income to the premium payer. Rev. Rul. 65-199 and 66-120.

The Government relies, in part, on Rev. Rul. 70-613. There, the life insurance company granted credit for 52 weekly premiums after payment directly to the company of an amount equal to the sum of 47 weekly premiums. The policyholder exercising such option was no longer entitled to the collection ser-

vices of the agent and all future premiums were to be paid directly to the company, saving the expense of the agent. Even more significantly, "no amount is paid or deposited by the policyholder in advance of the due dates of the premiums and there is no amount withdrawable by him." These circumstances are different from plaintiff's practice where the premiums are paid in advance, the discount is granted in advance, the services of the agent are not dispensed with, there is no expense savings to the Company, and the policyholder has the right to pay premiums in advance or to pay them weekly as they become due. The Court is of the opinion therefore that this ruling is not applicable to this case because of the dissimilarity of the facts.

Accordingly, the Court is of the opinion that the discounts for advance weekly premiums were in the nature of interest within the express terms of the provisions of the Code, 26 U.S.C. §805(e)(3), and Liberty National was entitled to deduct the amount of such discounts in the computation of its federal income tax liability for the years 1966 through 1969.

Issue No. II—Allocation of Deduction For Contributions To the Profit Sharing and Retirement Plan

Plaintiff allocated deductions for contributions to its Profit Sharing and Retirement Plan for the years 1966 through 1969 directly to the source of the profit as determined for federal income tax purposes. This "income" method of allocation is based on the ratio of gross income of each department to total income. The Government contends that the allocation to "investment expenses" and "insurance expenses" should have been on the basis of the "salaries method", i.e., ratio of current salaries and commissions in each category to total current salaries and commissions. The controversy is whether contributions of profit to the Plan should be considered an expense of the source of the profit or an additional salary expense for the people who ultimately receive the benefits.

Liberty National has a trusteed profit sharing and retirement plan (PS&R Plan), established in 1950, and qualified under Section 401 of the Internal Revenue Code. It is a contributory plan and each permanent, full-time employee who has completed one year of continuous service is required to be a member and to contribute 3 per cent of annual compensation not to exceed a certain amount. The Company has no obligation to make any contribution except out of profits. The Company annually contributes approximately 10 per cent of profits determined from the net gain from operations, the exact amount being determined prior to March 1 of the following year. This contribution is allocated by the Trustees to members' accounts without regard to departmental employment in accordance with the terms of the Plan, thus benefiting all full-time permanent employees with over one year's continuous service.

During each of the years in suit plaintiff allocated, for federal income tax purposes, PS&R contributions between investment expenses and insurance expenses proportionately on the basis of the ratio of the previous year's "gain from investment" and "gain from underwriting" as determined for federal income tax purposes.

Allocation to the source of profits followed the concept recognized in federal income tax law of attributing profits of a life insurer to its investment and underwriting operations. This allocation method is in accord with generally accepted accounting principles and recognizes the "cause and effect" rule of charging expenses to the revenue which generated the expense.

According to the testimony and writings of certified public accountants, allocation of contributions to profit sharing and retirement plans by either of two methods, the "income method" and the "salaries method" is acceptable. A member of a large public accounting firm, a certified public accountant with many years experience in life insurance company taxation, testified that, in his opinion, the most appropriate method of

allocation of contributions to the PS&R Plan was the "income method," as used by plaintiff. The allocations on the income method were "fairly chargeable" to the source of the income as expenses for federal income tax accounting purposes.

The Government urges that the contribution should be allocated to investment and insurance expense in the ratio of salaries and wages of employees in each department to the total salaries and wages of the Company. It is urged that this is merely an additional salary expense and chargeable as such. The Court is of the opinion that this misconstrues the nature of the contribution which is from profits. Allocation to source makes better sense and is in accordance with sound accounting principles. It does not seem logical to charge profits generated by one department and contributed to a PS&R Plan as an expense to another. The situation would be different if we were dealing with a retirement plan with predetermined contributions for each employee. In such a case the contribution would seem to be an additional salary expense, but not here where the contribution is solely on the basis of profits.

It would also appear that the use of the Government's method could produce distortions and anomalous results. A bad mortality experience for example could cause an increase in investment income. A decrease in profit because of mortality factors would cause a decrease in the amount charged to investment expense thereby increasing investment profit. Accordingly, this artificial formula would distort investment income by the application of factors which had nothing to do with it.

One of the significant characteristics of a profit sharing and retirement plan is that contributions made by the employer are necessarily dependent upon profits. In *Mississippi River Fuel Corporation* v. *Koehler*, 266 F.2d 190, 195 (8th Cir. 1959), the Court said:

> . . . The terms 'profit-sharing plan' and 'sharing trust' as used in said paragraph (C), refer to a particular type

of plan and trust under which employees are given a *share* in the *profits* of their employer, if and when such profits are realized. The applicable Treasury regulations above mentioned (Regs. 111, sec. 165-1, as amended) define a 'profit-sharing plan' to be one established and maintained by an employer 'to provide for the participation in his profits,' by his employees or their beneficiaries; and they further indicate, by comparison with a stock bonus plan, that one of the distinguishing characteristics of a profit-sharing plan is that it is 'necessarily dependent upon profits.' These regulations, in our opinion, provide a reasonable interpretation of the statute, and should be given effect. Thus, in order for a plan to qualify as a profit-sharing plan under paragraph (C), the plan must be geared to *profits;* it must be dependent upon the existence of *profits* as distinguished from operating funds out of which contributions of predetermined amounts are paid even though losses rather than profits are realized; and it must provide for the *sharing* or *participation* by the employees in such *profits* as they actually are realized.

Income Tax Regulations, Section 1.401-1(b)(1)(ii), recognize that:

> A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

4A Mertens, *Law of Federal Income Taxation,* Section 25B.06, Chapter 25B-page 24-25, states:

> A *profit-sharing plan* is a plan established and maintained by an employer for the primary purpose of permitting his employees or their beneficiaries to participate in his profits. Consequently, to be a profit-sharing plan under the Code, the plan must be integrally geared to and dependent on the employer's profits (past or current); a plan under which neither the employer's contributions nor employees' benefits are specifically related to or dependent on past or current profits is not a profit-sharing plan even though such contributions may in fact from time to time be made out of profits. Hence, the nature and purpose of a profit-sharing plan is patently different from that of a pension plan. To the extent that employer contributions under a pension plan are paid out of profits, the employee benefits can be said to be a form of sharing of profits of the employer. Nevertheless, in the technical sense, for purposes of the Code, a pension plan is not a profit-sharing plan even though a profit-sharing plan may be qualified under the Code where the shares are not paid to the employees before retirement.

Investment expenses are appropriate deductions in the calculations of taxable investment income. Internal Revenue Code, § 804. "General expenses" may be included in investment expenses. Code §-805(c)(1). "General expenses" are defined in Regulations § 1.804-4(b)(1)(ii) as "any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof." Since these contributions were for the benefit of all employees with more than one year of continuous service, the contribution is a "general expense." The criterion for allocating such general expense to investment expenses is that the general expenses must be "fairly chargeable" against gross investment income. Reg. § 1.804-4(b)(1)(i).

The general expense is fairly chargeable against gross investment income, since it was investment income which produced the contribution which then becomes the expense. This allocation method is not unlike that authorized in § 404(a)(3)(B) of the Code, which permits affiliated corporations to make contributions to a single profit-sharing plan, and to allocate the contributions among the companies in the ratio of their respective corporate profits to the contribution even though some non-contributing corporation may benefit thereby.

It also has a similarity to the situation in *Occidental Petroleum Corporation* v. *Commissioner,* 55 T.C. 115 (1970). There, the corporation was required to make contributions based on coal production to a union welfare and retirement fund. The taxpayer contended that 55 per cent of its union employees did not work at the face of the mine and that the payments were really a part of the cost of labor, rather than the cost of producing coal, and, should be apportioned on the basis of total direct expenses or on the basis of direct union labor costs rather than tonnage. The court held that the cost of the contributions could be directly identified and related to the production of coal and that the expense of the contribution should be allocated in direct proportion to the tonnage of the coal produced and not by a more indirect formula involving the cost of labor (at 126):

> The considerations advanced by petitioner do not counteract the hard fact that it is the production of the coal from the particular mine which generated the 40-cents-per-ton payment. The role of the labor element in producing coal is at best imprecise in view of the fact that the payments were not geared to the means of production, the type of coal produced, or the quality of the producing seam, all of which elements would appear to have a direct bearing on the cost of labor. Thus, an allocation on the basis of the cost of direct union labor would be inappropriate. The same is true, only more so, with respect to petitioner's claim that the UMW payments should be allocated on the basis of total direct expenses, which included such items as repairs, interest, taxes, and depreciation. Variations in the amounts of these items in any given year would obviously not be correlated with the amount of the UMW payments.
>
> Petitioner seeks to take a clearly identifiable element of cost that varies exactly in direct proportion to tonnage and treat it as an indirect cost to be allocated among the mining properties by an admittedly imprecise method of allocation. This it may not do. We hold that the UMW payments constitute direct costs chargeable to each separate mining property on a tonnage basis.

In *Occidental Petroleum* it was the production of coal which generated the obligation for payment into the fund. Here, it is the production of profit from the two major sources of profit which generated the contribution of profits to the plan. This direct allocation of a clearly identifiable and precise element of cost should be made directly rather than on an imprecise indirect basis based upon various other factors, including the salaries or compensation of the members. This direct allocation to the source of the profit recognizes the generally accepted accounting principle of cause and effect, and is more appropriate than an indirect allocation. The Fifth Circuit has recently held that to avoid undue distortion of income a life insurance company may deduct against income the expense to the company which will be occasioned by that income. *Great Commonwealth Life Insurance Company* v. *United States,* 491 F.2d 109 (5th Cir. 1974).

While the Company did not allocate the contributions between insurance and investment in Exhibit 5 of its annual statement, the evidence established that there was no specific instruction that it do so. It did reflect the actual total contribution in the Summary of Operations in the annual statement, and such method of accounting had been accepted by the supervisory of-

ficials and the NAIC examiners for many years. This sufficiently meets the requisites of Int. Rev. Code § 818(a).

The Court is of the opinion that the contributions by plaintiff to its PS&R Plan for the years in question constitute a general expense to the Company, a portion of which is "fairly chargeable" to investment expenses. The allocation of this expense on the basis of the ratio of profits generated from each of its two major departments to total profits was appropriate and permissible under the law. The Court is not persuaded by the contentions of the Government that Liberty National's profit contribution should be allocated on the more indirect formula of salaries and wages of members. Accordingly, the Court is of the opinion that the Government's claimed offset is due to be denied.

Issue No. III—Were the Additional Payments on Contributions to the PS&R Plan After the Due Date Deductible as "Interest Paid" Within the Meaning of Code Section 805(e)(1)?

Plaintiff's contribution of profit to its PS&R Plan is due to be paid within 60 days after the end of each calendar year. The Plan requires "interest" on contributions paid after the due date. Plaintiff contends that such additional payments are deductible as "interest paid" under Section 805(e)(1) of the Code. The Government contends that such payment simply constitute additional profit contributions to the Plan and are not deductible as "interest paid."

Since profits cannot be determined with any certainty for several weeks after the close of the year, the Board of Directors each year fixes the amount of the contribution during the last week in February. This time schedule created problems. The Company, to cope with substantial contributions to be made within a very short period of time, had to accumulate the cash by liquidating investments or foregoing investment oppor-

tunities for several weeks. The Trustees of the Plan immediately upon receipt of funds needed investments, the acquisition of which could take several days or weeks. To resolve these problems, the Plan was amended prior to the years in suit and approved by the Internal Revenue Service to provide (Pl.'s Ex. 23, ¶6, p. 3):

> Any portion of the contribution not paid over to the Fund after the amount thereof is established and prior to the first day of March of the year in which the contribution is made shall be increased by an interest payment on such sums. Such interest payment shall be computed on the basis of a rate per annum equal to the Federal Reserve Bank, Atlanta District, discount rate in effect on such date on such sums so paid from the said first day of March to the date of payment or payments to the Fund.

These additional sums were treated by the Trustees as fund earnings and allocated to members' accounts in proportion to the value of each account at the beginning of the year. This was different from the Company contributions to the Plan, which were allocated in accordance with a formula based on the amount of a member's deposits and length of service.

"Interest paid" deductible under Section 805(a) of the Code includes under § 805(e)(1) "all interest paid for the taxable year on indebtedness."

The amount of the Company's contributions to the Plan becomes a fixed obligation of the Company when it is set by the Board of Directors prior to March 1 of each year. This obligation to pay and the right of the Trustees to receive it is a contractual obligation. *Boase* v. *Lee Rubber & Tire Corporation,* 437 F.2d 527 (3rd Cir. 1970). See also, Annotation: "Pension Plan—Rights of Employee," 42 A.L.R.2d 461, 467. Interest is compensation allowed by law, or fixed by the parties, for the use or detention of money. *Daniel* v. *First National Bank of Birmingham,* 228 F.2d 803, 806 (5th Cir. 1956). It is but "just com-

pensation for the withholding of the principal." *De Movile* v. *Merchants and Farmers Bank of Greene County,* 237 Ala. 347, 358, 186 So. 704, 714 (1939).

The provision of the Plan, under which these additional payments are made, expressly denominates the payments as "interest" and fixes the rate. The treatment of these sums as "interest paid" in the annual statement of the Company is consistent with the manner required by the National Association of Insurance Commissioners so as to comply with § 818(a) of the Internal Revenue Code. See *Great Commonwealth Life Insurance Co.* v. *United States,* 491 F.2d 109, 116 (5th Cir. 1974). The Court concludes, therefore, that these additional payments are in fact "interest paid on indebtedness" within the meaning of § 805(e)(1) of the Code. The Government's claim offset on this issue is therefore due to be denied.

Issue No. IV—Allocation of General Advertising Expenses

Plaintiff taxpayer contends that the cost of its general advertising during the years in suit was a "general expense," a portion of which was "fairly chargeable" as an investment expense. The Government's contention is that Liberty National's advertising was designed solely to promote the purchase of insurance, was not directed at the borrowing public or mortgage loan brokers, that the investment operations received no benefit from such advertising, and that it was inappropriate to charge any of the general advertising expense as an investment expense.

Advertising, generally regarded as an investment in public recognition, falls into two broad categories: institutional, to promote the Company, and product, to promote a particular product or service. Plaintiff does both institutional and product advertising. Its product advertising seeks to promote the sale of specific insurance policies and plans, the expense of which was not charged to the Company's general advertising account and

is therefore not at issue here. The advertising expense here involved was "institutional" or "image" advertising, which was charged to the general advertising account, a part of which was allocated to investment expense.

In its general advertising plaintiff used road signs, calendars, displays in newspaper and trade magazines and brochures. The road signs were of three types—the general outdoor advertising sign along highways featuring the name of the Company, the picture of the Statue of Liberty, used as an identifying symbol, and the words "Service Is Our Best Policy"; school bus stop shelters for school children with the name Liberty National prominently featured; and signs bearing the name Liberty National in the vicinity of schools and at intersections with the warning "Protect Our Children." Signs in various localities displayed the name Liberty National and the name of its agent who worked in the community.

Newspaper and trade magizine advertising was used primarily to inform the public of Liberty National and identified its name and its business in general terms without the mention of any specific plan or policy of life insurance.

Calendars, featuring the name Liberty National, were of several types—small desk calendars, large wall calendars with maps of states in which the Company operated, and so-called almanac calendars, showing general information concerning the weather, the phases of the moon, sunrise, moonrise, etc.

Financial statements were published in various newspapers throughout the Company's operating territory. The Company contends this was intended to show its financial strength which would encourage recognition of the Company as a reservoir of funds available for lending and investment purposes.

National recognition of agents through industry sources were the subject of other newspaper advertising identifying the agents and the award on the theory that the public would "do business with winners."

Brochures told the "Liberty National Story" by giving pertinent facts concerning the Company, and featured local civic projects and points of community interest.

This Court is of the opinion that this general advertising benefited all departments of the Company, and served to increase and enhance its public recognition. While it would be difficult to make a precise allocation to these departments based on the benefit received, it is apparent that the general advertising did benefit the Company's investment program and some portion of it is therefore fairly chargeable as investment expense.

The Government does not challenge the precise allocation as such. It rather contends that nothing should have been charged to investment expense. Having determined that some portion is properly chargeable to investment expense, that effectively ends the matter since there is no attack on the allocation as such. However, the Court is of the view that the method here used was appropriate. General advertising expenses were allocated for federal income tax purposes between investment and insurance expense in the ratio of the gross investment income and gross insurance income to total income. This is in accord with the instruction manual prepared by Ernst & Ernst dealing with federal taxation of life insurance companies "National Training Program—1973 Federal Taxation of Life Insurance Companies" which recommended the allocation of general advertising expenses in the "ratio of gross income of the investment department to total gross income." (Pages 2-10-2-11). It is also in keeping with the Internal Revenue Service Manual entitled "Audit Technique Guidelines" as related to life insurance companies which recognized allocation of such expenses in the "ratio of gross or net income of Investment Department to total income" as appropriate. Section 125.4(13) of Manual.

In its annual statement for these years Liberty National did not allocate these general advertising expenses between investment expenses and insurance expenses, but failure to so allocate did not affect the net gain from operations as reported in the annual statements. There was no benefit to Liberty National from its failure to allocate the expense in its annual statement and does not invalidate its allocation method.

The general advertising expenses of the Company were allocated as follows:

YEAR	AS INVESTMENT EXPENSE	AS INSURANCE EXPENSE
1966	$71,180.30	$223,800.53
1967	84,839.60	301,507.94
1968	95,979.72	318,058.59
1969	63,640.15	209,379.60

The method of allocating general advertising expense used by Liberty National was, in the Court's opinion, fair and the portion allocated to investment expenses was "fairly chargable" to investment operations. Such allocation accorded with generally accepted accounting principles.

The cost of good will or investment advertising designed to keep the name of a business enterprise before the public is a deductible business expense if related to expected future patronage. Regulation Section 1.162-20(a)(2); 4A Mertens, *Law of Federal Income Taxation,* Section 25.38, p. 195.

The Court finds that these general advertising expenses of Liberty national were in the nature of "institutional" and "good will" advertising, which could reasonably be expected to benefit the entire Company and all department thereof; and that the portion charged to investment expenses was "fairly chargeable." Regulation 1.804-4(b).

The Court is of the opinion therefore that the Government's asserted offset for improper allocation of such expenses is due to be denied.

Issue V—Allocation of Payroll Taxes

The Government contends, and the plaintiff agrees, that for the tax years in controversy the method which Liberty National used to allocate its payroll taxes between investment expenses and insurance expenses was inaccurate in that it failed to take into account the commission payments made to its agents. The parties stipulated, and the Court finds, tht the correct allocation should have been as follows:

Allocation of Payroll Taxes

YEAR	AS INVESTMENT EXPENSES	AS INSURANCE EXPENSES	TOTAL
1966	$110,311.71	$1,006,209.25	$1,116,520.96
1967	126,086.01	1,063,374.36	1,189,460.37
1968	142,539.38	1,162,991.05	1,305,530.43
1969	138,246.58	1,241,118.26	1,379,364.84

Issue VI—Government's Claim of a Limitationon the Amount of Refund for the Year 1966

The Government contends that even if Liberty National is entitled to recover that it is nevertheless limited in the amount for recovery for the year 1966 to assessments paid within two years of the filing of a claim for refund. Liberty National denies this contention.

In its tax return for 1966, filed on September 18, 1967, plaintiff claimed an "interest paid" deduction for discounts in the nature of interest of $279,010.43. Upon initial government audit, an adjustment was made increasing this deduction by $186,006.57, bringing the total allowed deduction to $465,017.00. Other audit adjustments at the same time resulted in the assessment of additional tax which was paid in 1969. At this stage in the audit process, then, plaintiff has been allowed a deduction for the total amount of the discounts granted for advance payment of weekly premiums.

The audit process of the 1966 return was not complete, however, and on June 25, 1970, the parties executed IRS Form 872, extending the period for assessments. Three additional agreements extended the assessment period to December 31, 1971. In October 1971, the Government reversed its position and disallowed the entire deduction, which, of course, resulted in the assessment of additional taxes. Plaintiff paid the assessment and filed claim for refund on May 23, 1972, within six months after the end of the extended period for assessment.

Generally, claims for refund must be filed within three years from the time the return was filed or within two years from the time the tax was paid, whichever is later. Int. Rev. Code § 6511(a). It is also the general rule that where the claim for refund is filed within the three-year period, the amount of the claim may not exceed the portion of the tax paid within such three-year period plus the period of any extension of time for filing the return. Int. Rev. Code § 6511(b)(2)(A). However, special rules apply where the parties agree, pursuant to Code § 6501(c)(4), to extend the period during which an assessment may be made by the Government. If the agreement extending the assessment period is made within three years of the filing of the return and if a claim for refund is filed within six months after the expiration of the agreed extended period, then the amount of refund may include not only the amount of tax paid after the execution of the extension agreement but also the portion of the tax paid within three years of the filing of the return. Code § 6511(c)(2). Here, since the agreement was made on June 25, 1970, the amount of refund which may be granted on Liberty National's claim includes not only the amount of taxes paid during the assessment extension period but also the amount of tax paid from the date of the tax return (September 18, 1967) to the date of the extension agreement (June 25, 1970).

To hold otherwise would be to penalize a taxpayer for agreeing to extend the period during which the Government might assess additional taxes. Although Liberty National filed its

return for 1966 on September 18, 1967, it was not until more than four years later, in October, 1971, that the Goverment disallowed the deductions claimed by Liberty National upon the initial audit. Until the Government disallowed the deduction, Liberty National had no reason or ground upon which to file its claim for refund. It filed its claim within eight months after the Government disallowed the deduction and assessed additional taxes and within six months after the end of the extended period during which the Government could make an additional assessment.

The Government recognizes these special rules where extension agreements are made but insist that two of the extension agreements in this case were "restricted" and, therefore, should not be accorded the office of an unrestricted extension agreement. The "restrictions" limited the deficiency assessment to that resulting from the deduction of the discount on prepaid premiums as "interest paid" which was then in dispute and which forms the basis for this suit. They, therefore, had no such limiting effect upon the statutory provisions granting special rules for the amounts recoverable where such periods of assessment have been extended. The Court is of the opinion therefore that the limitation urged by the Government is due to be rejected.

Conclusion

The Court concludes therefore that plaintiff is entitled to recover the taxes which the Court has determined were erroneously assesed for the years 1966 through 1969, with the offset on payroll taxes herein allowed. The parties are directed to compute the proper amount of the judgment to be entered and submit the computation to the Court within 60 days for the entry of proper judgment in accordance with this Memorandum Opinion.

/s/ Frank H. McFadden
Chief Judge

Dated: November 17, 1976

In the United States District Court For the
Northern District of Alabama, Southern Division

Liberty National Life
Insurance Company,
Plaintiff

vs.

United States of America,
Defendant

Civil Action
No. 73-M-1035

Amendment to Memorandum Opinion

(Filed December 8, 1976)

The Memorandum Opinion of this Court dated November 17, 1976 is amended in that part dealing with ISSUE V—ALLOCATION OF PAYROLL TAXES by substituting the following table for that appearing in the Memorandum Opinion at page 25:

Allocation of Payroll Taxes

YEAR	AS INVESTMENT EXPENSES	AS INSURANCE EXPENSES	TOTAL
1966	$32,915.47	$1,083,605.49	$1,116,520.96
1967	37,555.01	1,151,905.36	1,189,460.37
1968	42,983.94	1,262,546.49	1,305,530.43
1969	42,514.70	1,336,850.14	1,379,364.84

/s/ Frank H. McFadden
Chief Judge

Dated: December 8, 1976

APPENDIX B

LIBERTY NATIONAL LIFE
INSURANCE COMPANY
Plaintiff-Appellee,

v.

UNITED STATES of AMERICA
Defendant-Appellant.

No. 77-1578

United States Court of Appeals, Fifth Circuit

Aug. 13, 1979

Internal Revenue Service disallowed an insurance company's tax treatment of discounts granted to policyholders for advance payment of premiums for industrial life insurance. The insurance company prevailed in the United States District Court for the Northern District Court for the Northern District of Alabama, Birmingham, Frank H. McFadden, J., and the Government appealed. The Court of Appeals, Thornberry, Circuit Judge, held that: (1) for purposes of determining whether the discounts were "in the nature of interest" and thus deductible by the insurance company for income tax purposes, objectively rational explanations for the company's granting of such discounts were relevant, but ultimately company's subjective reasons were controlling, and (2) in view of size of the discounts, in view of company's tax treatment of such discounts otherwise and in view of direct testimony as to the company's actual reason for granting the discounts, they were not discounts "in the nature of interest."

Reversed.

1. Internal Revenue (key)517

For purposes of determining whether insurance premium discounts granted to policyholders for advance payment of industrial life premiums were "in the nature of interest" and thus deductible by insurer for income tax purposes, objectively rational explanations for company's granting of such discounts were relevant, but ultimately company's subjective reasons were controlling. 26 U.S.C.A. (I.R.C.1954) §§ 801-820, 802(b)(1, 2), 804, 804(e), 805, 805(e)(3), 809, 809(a)(2); Revenue Act of 1921, § 245(a)(8), 42 Stat. 227.

2. Internal Revenue (key)1690

Ultimate issue whether insurance premium discounts were "in the nature of interest" and thus deductible by insurance company for income tax purposes was question of law, but underlying issue why company granted discounts was factual, and subject to clearly erroneous standard of review. 26 U.S.C.A. (I.R.C.1954) § 805(e)(3).

3. Internal Revenue (key)2161

In tax refund suit, burden is on taxpayer to prove by preponderance of evidence that its position is correct.

4. Internal Revenue (key)517

In view of size of discounts granted by insurance company to policyholders for advance payment of premiums, in view of company's tax treatment of such discounts otherwise and in view of direct testimony as to the company's actual reason for granting the discounts, they were not discounts "in the nature of interest," deductible as such by company for income tax purposes. 26 U.S.C.A. (I.R.C.1954) §§ 801-820, 802(b)(1, 2), 804, 804(e), 805, 805(e)(3), 809, 809(a)(2), (c), (d)(11, 12),(e)(1), 810(c), (c)(5), 6049; Revenue Act of 1921, § 245(a)(8), 42 Stat. 227.

See publication Words and Phrases for other judicial constructions and definitions.

Gilbert E. Andrews, Act. Chief, App. Section, M. Carr Ferguson, Asst. Atty. Gen., Gary R. Allen, James E. Crowe, Attys., U. S. Dept. of Justice, Washington, D. C., Tax Div., for defendant-appellant.

Ralph B. Tate, Ira L. Burleson, Theron A. Guthrie, Jr., Birmingham, Ala., for plaintiff-appellee.
ingham, Ala., for plaintiff-appellee.

Appeal from the United States District Court for the Northern District of Alabama.

Before THORNBERRY, GOLDBERG and GEE, Circuit Judges.

THORNBERRY, Circuit Judge:

Once again[1] we are asked to enter the "fantasy world of life insurance company accounting and taxation." *Western Nat'l Life Ins. Co.* v. *Commissioner*, 51 T.C. 824, 830 (1969). The issue we must decide is whether discounts taxpayer Liberty National Life Insurance Company gave to holders of its industrial life insurance policies who paid at least twenty-six weeks of premiums at one time were "discounts in the nature of interest" within the meaning of I.R.C. § 805(e)(3).

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[1]*See, e. g., Republic Nat'l Life Ins. Co.* v. *United States*, 594 F.2d 530 (5 Cir. 1979); *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d 627 (5 Cir. 1977), cert. denied, 435 U.S. 995, 98 S.Ct. 1647, 56 L.Ed.2d 84 (1978); *Great Commonwealth Life Ins. Co.* v. *United States*, 491 F.2d 109 (5 Cir. 1974); *Mutual Savings Life Ins. Co.* v. *United States*, 488 F.2d 1142 (5 Cir. 1974).

I

A.

"Industrial life" insurance originated in nineteenth century England as a means of selling life insurance to the industrial workers who generally could not pay the relatively large annual premiums required by "ordinary" life policies. Three characteristics generally distinguish industrial policies from other types of life insurance. The premiums on industrial life policies are paid weekly rather than monthly or annually. The face amount of such policies is typically and, in some states, required to be less than $1,000. Last, an agent of the company collects the premium personally at the policyholder's home or place of employment. *See generally,* M. Davis, Industrial Life Insurance in the United States (1944). Although the weekly premiums for industrial policies are quite small, usually less than a dollar, the total premium the policyholder pays over the term of the policy is substantially higher than for an equivalent amount of ordinary life insurance.

B.

Brown-Service Insurance Company, a predecessor of taxpayer, issued burial insurance policies, which provided funeral benefits on the death of the insured. Like industrial policies, the burial policies allowed payment of premiums weekly and in small amounts. In the 1930's, however, Brown-Service began to have financial difficulties and became desperate for fund with which to pay its operating costs and claims. To obtain these funds, Brown-Service encouraged its policyholders to pay several weeks premiums in advance and granted a discount to the policyholders who did so.[2] Brown-Service's practice of

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[2]The Instruction Book for Brown-Service agents directed:

> A discount of 10% will be allowed on all premiums paid for 52 or more advance weeks.
>
> A discount of 5% will be allowed on all premiums paid for 26 advance weeks. No discount will be allowed on premium payments in cases where less than 26 advance weeks are paid.

granting discounts became well-known and enabled the company to survive the depression. Brown-Service then began to issue industrial life policies and made the discounts available on these policies also.

In 1944, Brown-Service merged with Liberty National Life Insurance Company, the latter company surviving. Prior to the merger, Liberty National had issued industrial life insurance, but had not granted discounts. After the merger, Liberty National wished to combine the operations of the two companies and to provide services to policyholders in a uniform manner. Therefore, the surviving company adopted and formalized Brown-Service's practice by including in its own policies provisions granting a five percent discount on premiums paid twenty-six weeks in advance and a ten percent discount on premiums paid fifty-two weeks or more in advance.[3] In 1967, Liberty National eliminated this language from newly issued policies, but continued to grant the discounts to holders of these new policies as well as to the holders of policies containing such provisions.

C.

Throughout the history of the federal income tax, Congress has realized that, because of their unique financial structures, life insurance companies should not be taxed under the relatively simple formula applicable to most businesses. *See Commissioner* v. *Standard Life & Accident Ins. Co.*, 433 U.S. 148, 97

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[3] The wording of these provisions varied, but a typical policy-provided:

> (3)PREMIUM DISCOUNTS—Whenever premium payments are made for a period of 26 weeks in advance at one time, the Insured shall be given a discount equal to 5% of the total of such premiums paid in advance; and whenever premiums are made for a period of 52 weeks in advance at one time, the Insured shall be given a discount equal to 10% of the total of such premiums paid in advance.

S.Ct. 2523, 2526-27, 53 L.Ed.2d 653 (1977). From 1921 until 1958, Congress taxed only the investment income of life insurance companies, and did not impose any tax on amounts the companies received as premiums on outstanding policies. The 1921 Act also allowed life insurers a deduction for "[a]ll interest paid or accrued . . . on . . . indebtedness." Revenue Act of 1921, ch. 136 § 245(a)(8), 42 Stat. 227, 262. While later variations of this provisions were in effect, *see* 8 J. Mertens, The Law of Federal Income Taxation § 44.41 (1978 rev.), two life insurance companies attempted to deduct as "interest paid" discounts they had granted on premiums paid in advance. The Commissioner disallowed these deductions and the courts affirmed, holding:

> The money paid in advance by an insured to the company is not borrowed money. No indebtedness arises on the part of the company on the receipt of the money. The discount allowed is not payment for the use of borrowed money. The discounted sum received is the present value of the future amount due. The amount of the discount is the amount the company expects to earn by the use of the money before the regular due date of the premium. This amount added to the discounted value is expected to equal the amount payable on the due date had the premium not been paid in advance. This is in no sense interest on an indebtedness.

Commissioner v. *Monarch Life Ins. Co.*, 114 F.2d 314, 326 (1 Cir. 1940), *affirming* 38 B.T.A. 716 (1938); *Illinois Life Ins. Co.* v. *Commissioner,* 30 B.T.A. 1160 (1934), *aff'd on other grounds,* 80 F.2d 280 (7 Cir. 1935), *rev'd on such other grounds,* 229 U.S. 88, 57 S.Ct. 63, 81 L.Ed. 56 (1936). In *Equitable Life Assurance Soc'y* v. *Commissioner,* 44 B.T.A. 293 (1941), *modified and aff'd on other grounds,* 137 F.2d 623 (2 Cir. 1943), *aff'd,* 321 U.S. 560, 64 S.Ct. 722, 88 L.Ed. 927 (1944), however, the court found that an economically equivalent practice created an

allowable deduction for interest paid. Rather than merely giving policyholders a discount on premiums paid in advance, Equitable collected premiums under a "premium deposit agreement." In this agreement, Equitable contracted to accept funds from policyholders, to supplement them with accrued interest at a specified rate, and to apply the funds and interest to the payment of premiums as they became due. The Board of Tax Appeals found that the interest Equitable paid on the premium deposits was properly deductible as interest paid on an indebtedness. 44 B.T.A. at 310.

In 1959, Congress undertook a major revision of the income tax laws affecting life insurance companies. Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112 (codified at I.R.C. §§ 801-820). This revision created a three phase procedure for the taxation of such companies. *See* 8 J. Mertens, The Law of Federal Income Taxation § 44A.04 (1978 rev.). The total tax liability of a company is based on the sum of amounts derived under each of the three phases. Each phase is determined by comparing two types of income, "gain or loss from operations," and "taxable investment income." Gain or loss from operations is the sum of the company's income from all sources, including the company's share of investment income and premiums received, minus the expenses of operation and payment of claims and dividends to policyholders. I.R.C. § 809. In computing the gain or loss from operations, only a portion of total investment income is included. Congress recognized that life insurance companies must provide for projected liabilities to their policyholders by establishing reserves to satisfy future claims, and therefore, that any income necessary to increase these reserves should not be taxed. The Code effectuates this recognition by dividing the total investment income between a nontaxable policyholders' share and a share belonging to the company, which is taxable. To determine the portion of investment income includible within the company's gain or loss from operations, the company must divide its "required interest" by

the "investment yield." The required interest is basically the amount of reserves a company is required to maintain to satisfy policyholders' claims. I.R.C. § 809(a)(2). Investment yield is the company's gross investment income less specified deductions such as expenses attributable to the investments, depreciation, and depletion. I.R.C. § 804(c).

Taxable investment income is comprised solely of the company's share of its total investment income. I.R.C. § 804. In computing taxable investment income, however, a different formula from that employed in determining gain or loss from operations is used in computing what portion of the total investment income belongs to the company. The taxable investment income formula requires that the company divide its total "policy and other contract liability requirements" by the investment yield. The policy and other contract liability requirements include largely the same items included in the required interest for gain or loss from operations, but these items are determined in a slightly different manner. I.R.C. § 805. One of the items included in policy and other contract liability requirements is "interest paid." I.R.C. § 805(e)(3). It is the element that is at issue in this case.

We are concerned only with the first two phases of the life insurance company taxing formula. Phase I is the lesser of taxable investment income and gain from operations. I.R.C. § 802(b)(1). Phase II imposes a tax on fifty percent of the excess, if any, of gain from operations over taxable investment income. I.R.C. § 802(b)(2). Although it is unclear from the record, the parties and lower court apparently agree that Liberty National's gain from operations exceeded its taxable investment income for the years in question and that the latter therefore was the Phase I tax base. This case arose because taxpayer treated the discounts on its industrial policies as interest paid on its returns. This treatment increased the policyholders' share of the total investment income and therefore decreased the taxable investment income and Phase I tax base of Liberty National. In short,

because the company claimed the discount as interest paid, it paid less tax. The I.R.S. disallowed this treatment and taxpayer is now seeking a refund.

D.

The Code explicitly recognizes that the interest paid deduction includes "discounts in the nature of interest" on prepaid premiums. I.R.C. § 805(e)(3).[4] Although the legislative history of the 1959 Act provides little insight,[5] the district court reasonably believed that Congress intended this provision to change the law declared in *Illinois Life* and *Monarch Life, supra,* and to allow a deduction for interest given either by discounts on prepaid premiums or through a premium deposit agreement. *See also Liberty Life Ins. Co.* v. *United States,* 594 F.2d 21, 26 (4 Cir. 1979), *petition for cert. filed,* 47 U.S.L.W. 3814 (U.S. June 19, 1979) (No. 78-1825).

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[4]That section provides that interest paid includes:

> All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

[5]The only helpful reference to § 805(e)(3) in the legislative history are passages in the congressional reports stating:

> All of the interest payments included under this provision are similiar in nature to the deduction for interest paid or credited on deposits by a bank and therefore properly are not taken into account in determining the income of the life insurance company making the payment.

S.Rep.No.291, 86th Cong., 1st Sess. 16-17 (1959), *reprinted in,* [1959] U.S.Code Cong. & Admin.News pp. 1575, 1591. *See also* H.R. Rep.No.34, 86th Cong., 1st Sess. 10.

Whatever the impetus for the passage of section 805(e)(3), it is clear that only discounts "in the nature of interest" may properly be deducted under that provision. Interest is usually defined as the price paid for the use of money. Liberty National argues that the entire amount of the discounts granted were interest and therefore deductible. The United States counters that, although a small portion of the discount may be attributable to interest, the substantial majority of the discount was granted for reasons other than payment for the use of policyholders' money. The district court accepted the arguments of Liberty National and held that the entire discount was properly deductible. *Liberty Nat'l Life Ins. Co.* v. *United States,* 77-1 U.S.T.C. ¶9107 (N.D.Ala.1976). The judge below reasoned that, as taxpayer's experts testified, three factors are generally considered in premium rate computation: mortality, expense, and interest. The mortality factor is the expected incidence of claims due to the deaths of insureds. The expense factor is the portion of premiums needed to pay the expenses of operating the company. The interest element is the expected earnings from investment of premiums. The profit a company wishes to enjoy from a policy is typically accounted for by adjusting the expense element in the company's favor. The judge found that the mortality factor was unaffected by the frequency of premium payment because the insured's life expectancy was unaffected by how he paid the premiums on his policy. The judge also concluded that the discount given by Liberty National was not attributable to decreased expenses on policies paid at least 26 weeks at one time. The company paid its agents the same salary and commission regardless of how frequently they collected premiums. Furthermore, granting the discount actually increased the company's costs in handling the premiums because it had to hire additional accounting personnel. Therefore, the court concluded that the entire discount was interest. As additional support for its conclusion, the court relied on two other factors. First, it recognized that Liberty National had adopted the practice of granting discounts from its predecessor, Brown-Service and that

Brown-Service had clearly instituted the discount to acquire its policyholders' payments in advance of their due date. Second, the judge relied on Treasury Regulations and Revenue Rulings that indicated that certain discounts on life insurance premiums were interest. Treas.Reg. § 1.805-8(b)(3) (1960); Revised. 66-120, 1966-1 C.B. 14; Rev.Rul. 65-140, 1965-2 C.B. 20.

II.

The United States challenges the district court's opinion in two ways. First, it argues that it presented sufficient evidence to prove the existence of an additional factor used in computing the premium rates and that the district court incorrectly rejected this evidence. The government asserts that if a policyholder pays the premiums on his insurance policy annually, the policy will likely remain paid up and in force longer than if the policyholder made weekly payments. This tendency is called "persistency." In support of its argument, the government presented computer studies and expert testimony that purported to show that policies on which the holders made a single annual payment would experience greater persistency over the first years of the policy than policies on which the holders made weekly payments. Furthermore, taxpayer's own witnesses testified that the persistency of a policy affected its profitability. The court refused to adopt this argument, however, because the government witness based his calculations on virtually arbitrary assumptions about taxpayer's expenses and the lapse rates on taxpayer's expenses and the lapse rates on taxpayer's policies which were later shown to be incorrect. Furthermore, the studies attempted to predict the effect of annual payments on the policies' persistency only during the first years of the policies. Although life insurance policies experience the greatest lapse rate during their first years, only a very small percentage of taxpayer's industrial life policies on which the discount was granted were new policies. Thus, the studies were largely irrelevant to taxpayer's persistency experience. Third, the studies

showed only that the discounted policies experienced increased persistency during the year that the annual payment was in effect. They failed to predict whether the holders of those policies were more or less likely to renew the policies than those who paid weekly. One of taxpayer's witnesses, in fact, testified that because the weekly premium payers may have acquired a habit of paying the smaller weekly premiums whereas the yearly premium payers had acquired no such habit and, to be eligible for the discount, would have to again make a large payment at the end of the annual period, those who paid annually may be more likely to allow their policies to lapse over the life of the policy.

[1,2] Last, and perhaps most importantly, the district court held that even if granting the discounts did improve the persistency of taxpayer's policies, there was no evidence that taxpayer based the granting or amount of the discount on any expectation of improved persistency. The United States implies that taxpayer's reasons for granting the discount are irrelevant, that if the discount actually improves the persistency and profitability of taxpayer's policies then the discount cannot be in the nature of interest. In other words, the government asserts that we must decide the objective question which of the rate computation factors does the discount most significantly promote rather than the subjective issue why did this taxpayer grant the discount. We disagree. As we indicate below, the objectively rational explanations for the taxpayer's actions are certainly relevant in determining the most likely subjective reason for those actions, but ultimately the taxpayer's subjective reasons for granting the discount must determine whether the discount was given for the early use of the policyholders' money. If Liberty National actually ignored any effect persistency may have had on its profitability and rate computation, we cannot now say that it should be taxed as if it had considered this factor. Because adequate evidence supports the district court's factual determinations that the government's witness and studies

were not credible and that taxpayer did not base the discount on any expectation of increased persistency, we conclude that these determinations were not clearly erroneous.[6]

III.

[3] The government's second and more general argument is that even if it failed adequately to prove that taxpayer specifically considered the effect of persistency on the profitability, the taxpayer nevertheless failed to show the discount was interest. In a tax refund suit the burden is on the taxpayer to prove by a preponderance of the evidence that its position is correct. *United States* v. *Janis,* 428 U.S. 433, 96 S.Ct. 3021, 3025, 49 L.Ed.2d 1046 (1976); *Carson* v. *United States,* 560 F.2d 693, 695-96, (5th Cir. 1977). The judge below held that Liberty National met this burden. He accepted Liberty National's argument that it established its rates by reference to only three factors: mortality, expense, and interest. Because the judge also found that Liberty National did not give the discount in anticipation of either more favorable mortality experience or reduced expenses, he felt that the discount was logically attributable only to the interest element and was therefore deductible. While this syllogistic approach to factual findings may generally be valid, in this case there is inadequate support for either the minor premise or the conclusion.

A.

Several types of evidence combine to convince us that taxpayer's discounts were not in the nature of interest. The scheer

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[6]Although the ultimate issue of whether the discounts were in the nature of interest is one of law, the underlying issue why taxpayer granted the discount is factual and subject to the clearly erroneous rule on review. *Cf. Slappey Drive Ind. Park* v. *United States,* 561 F.2d 572, 585 (5 Cir. 1977) (whether corporation was formed with purpose avoiding income tax is a question of fact.)

magnitude of the discount initially encourages us to discover some other explanation for the practice. Although the discounts were declared to be ten percent on premiums paid at least fifty-two weeks at one time, because taxpayer gave the discounts at the time the policyholder paid the premiums the effective rate of interest on the fifty-one payments that were not yet due was approximately twenty-four percent.[7] This high rate is in sharp contrast to the four and one-half percent interest taxpayer gave to holders of its ordinary life insurance under premium deposit agreements and to the approximate six percent return that taxpayer earned on its investments. It somewhat strains our credulity that a life insurance company, whose very existence depends on keen financial planning and investment, would for over twenty years be so desperately in need of liquid funds that it would be willing to pay one group of policyholders twenty-four percent interest to acquire those funds immediately without offering other policyholders similar incentives and without being able to recapture that expenditure through its own investments.

Taxpayer and the district judge posit three reasons that, despite its size, the discount was given as interest. First, they emphasize that taxpayer adopted the practice from its predecessor,

[7]The following table shows the effective annual rate of interest under various assumptions as to the number of weeks for which premiums are paid at one time:

Weeks Paid	Discount	Effective Annual Rate of Interest
26	5%	24.0342%
39	5%	15.2194%
51	5%	11.3664%
52	10%	24.4734%
78	10%	15.5999%
104	10%	11.4447%
156	10%	7.4652%
260	10%	4.4025%

Brown-Service, and that the predecessor clearly granted the discount to its policy holders in payment for the early use of the advance premiums. Brown-Service inititated the discount in order to increase its available cash in the 1930's. From this historical fact, the district court reasoned that the discount granted by Liberty National in 1966 through 1969 was also interest. He stated: "One cannot, a quarter of a century later, say that what was done for specific reasons really was done for different reasons . . . It was interest then; it is interest now." This analysis is faulty. That the discount originated as interest does not mean that it must retain that character in perpetuity. Liberty National adopted the discount in 1944 and continued to grant the discount on newly issued policies through the years in question. There is no indication that Liberty National was in unusual need of funds either in 1944 or at any time since. Taxpayer has totally failed to explain why it would have been willing in 1966 through 1969 to provide such a great discount merely to have the early use of its policyholders' money.

The district judge explained his finding that the discount was interest despite its size in a second way also: "Although there may be some valid distinctions between interest and discounts, for tax purposes these distinctions are of little significance. *Dixon* v. *United States,* 224 F.Supp. 358, 364 (D.C. N.Y.1963) [*aff'd,* 333 F.2d 1016 (2 Cir. 1964), *aff'd,* 381 U.S. 68, 85 S.Ct. 1301, 14 L.Ed.2d 223 (1965)]." This reliance on *Dixon* and its analysis was unfounded. The *Dixon* court was concerned with whether the discount on a bond was taxable as ordinary income or as capital gain. There was no question that the discount was granted as payment for the use of money. Within the context of that opinion it is clear that the court merely held that, for purposes of classification as ordinary income or capital gain, there is no difference between interest and a discount in the nature of interest. Thus, *Dixon* is of little help in this case which concerns totally different sections of the Code and in which the crucial issue is that assumed in *Dixon,* whether the discount is in the

nature of interest. The trial judge's reliance on Rev.Rul. 66-120, 1966-1 C.B. 14; Rev.Rul. 65-199, 1965-2 C.B. 20, and Treas.Reg. § 1.805-8(b)(3) (1960), is equally unfounded. The examples and directions given in those provisions are also based on the assumption that the discounts involved are in the nature of interest or are "the discounted value of the corresponding contract premiums . . ." Rev.Rul. 66-120, 1966-1 C.B. 14, 15.[8]

It is a basic accounting principle that discounts may be granted for various reasons, only one of which in interest. R. Wixon, Kell & N. Bedford, Accountants' Handbook 11:20 (5th ed. 1970). The Code redognizes this principle by limiting the discounts that may be deducted to those "in the nature of interest." By declaring that there was no significant difference between interest and discounts, the judge below assumed away the very issue he was to decide. Because we disagree with the district's court's reasoning, we believe that the very size of the discount taxpayer gave is some evidence that the discount was not in the nature of interest.

B.

A second type of evidence also causes us to believe that the discount was not interest. Other than the claim that the discount shoud be deductible as interest paid, taxpayer's treatment of the discount was inconsistent with its assertion that the discount was interest. It is undisputed that if the discounts were interest paid by taxpayer, they were also interest income to the policyholders. Rev.Rul. 66-120, 1966-1 C.B. 14; Rev.Rul. 65-199, 1965-2 C.B. 20. If any of the discounts exceeded ten

[8]Conversely, the government's reliance on Rev.Rul. 70-613 1970-2 C.B. 13, is also misplaced. As the district court recognized, that Ruling assumes that the discount involved was attributable to a "reduction in the expense (loading) element of the contract premium," rather than to interest.

dollars, the Code required the taxpayer to submit informational returns to the I.R.S. on form 1099. I.R.C. § 6049. Approximately 3,000 of Liberty National's 3,000,000 industrial life policyholders received a discount of more than ten dollars yet Liberty National failed to file 1099 forms with the I.R.S. for any of these policyholders. Taxpayer asserts that it realized it should file the required forms for its policyholders, but because its decentralized method of bookkeeping would make such filings very expensive that it consciously decided to disobey the law. We find this argument unconvincing. If Liberty National wishes to enjoy the benefits of deductions allowed by the Code, it must also suffer the expense of filing the proper records with the I.R.S.

The information taxpayer filed in its own returns is even more revealing. To determine a life insurance company's gain from operations, the Code requires the company to report as premium income the gross amount of premiums received. I.R.C. § 809(c). If a company receives premiums on which it has granted a discount attributable to interest, it must report the full premium stated in the contract, including both the money actually received and the discount. Treas.Reg. § 1.809—4(a)(1), T.D. 6610, 1962—2 C.B. 154, 156. This is referred to as "grossing up" the premiums. On the other hand, if the discount is attributable to factors other than interest, such as expense or mortality savings, the company need only report the money it actually received from the policyholder, the contract premium minus the discount. In this second situation, the taxpayer reports the premiums "net of the discount." Rev.Rul. 70—613, 1970—2 C.B. 137. Liberty National effectively reported only the amounts actually received from the policyholder as premium income.[9] Thus, in determining its gain from operations, tax-

[9]For the years 1966-67, taxpayer reported the premiums it received net of the discount as premium income. For the years 1968—69, taxpayer properly grossed up its premiums in reporting premium income, but then deducted the amounts given as discount under the category for "Other Deductions." Although I.R.C. § 809(d)(11) (as

payer treated the discounts as if they were attributable to expense or mortality savings rather than to interest. The district judge apparently believed that Liberty National's actions were sanctioned by the Internal Revenue manual.[10] The Manual provides no support for taxpayer's actions. The provisions cited by the district court is only a summary of the treatment to be accorded discounts in the nature of interest on advance premiums and is explained in more detail in Revenue Rulings. Rev. Rul. 71-64, 1971 C.B. 207; Rev.Rul. 66-36, 1966-1 C.B. 171. These Rulings indicate that, as the Manual states, when premiums are received in advance, only the actual amount received is reported as premium income in the year of receipt. The Rulings explain further, however, that if the discount is in the nature of interest, it must be reported as premium income when the premium becomes due. Liberty National failed to report the discount as premium income at any time. Therefore, its treatment of the discount in the gain from operations portion of its tax return is inconsistent with its contention that the discounts were in the nature of interest.

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amended in 1976, formerly § 809(d)(12)) allows life insurance companies to deduct items that other taxpayers are allowed to deduct, this allowance is specifically limited by § 809(e)(1), which states: "In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c)," which enumerates the items to be taken into consideration in computing the company's required interest. I.R.C. § 810(c)(5) includes within required interest any amounts paid as discounts in the nature of interest. Thus, even if we accept taxpayer's argument that the discounts were in the nature of interest, it improperly included those discounts within the category of other deductions. *See* Rev.Rul. 71—64, 1971—1 C.B. 207. Of course, because of the result we reach, the proper course for Liberty National would have been to report the premiums it received net of the discount and to treat the discounts as neither other deductions nor as includible within its required interest.

[10] Part IV, Vol. 3 Internal Revenue Manual, Audit Technique Guidelines Relating to Specialized Industries § 125.9(3) (Tax Analysts and Advocates ed. 1974), states: "When advance premiums are received at a discount, only the actual amount recieved is includable in gross premium income."

C.

Although the above facts indicate a probability that the discount Liberty National granted its policyholders was not in the nature of interest, they do not explain the true reason for granting the discount. This evidence may well be enough to rule in favor of the government, but we do not need to speculate on this possibility, however, because taxpayer's own witnesses indicated beyond doubt that Liberty National granted the discount for reasons entirely apart from the desire to obtain the early use of its policyholders' money. William Graves, Vice-president and Chief Actuary, and James Livingston, Jr., Senior Vice-president of Liberty National provided at least five reasons why taxpayer adopted the practice of granting discounts and continued it through the years in question. They testified that Liberty National wanted to maintain good relations with former Brown-Service policyholders, who expected to be granted the discounts even though neither Brown-Service nor Liberty National originally had any contractual obligation to continue the practice; to avoid confusion in their bookkeeping from having one method of accounting for advance industrial premiums on which discounts were given and another method for such advance premiums that were not allowed the discount; to enable their collecting agents to compute the premiuim simply without confusion about whether the policy allowed the discount or not; to retain the loyalty of the Brown-Service agents who were accustomed to granting the discount; and, to improve its competitive position by allowing customers who received their income at particular times of the year, such as farmers, to pay when they had the money. None of these purposes indicate that the discount was given as interest. According to this testimony, Liberty National allowed the discount not as payment for the early use of the policyholders' money, but as a convenience to itself and its policyholders. If they must be categorized, the reasons for granting the discount appear to place it within the expense element of rate computation. This testimony, combined

with the other evidence we discussed above, indicates that the district court was clearly erroneous in concluding that taxpayer intended the discount as payment for the use of money. Therefore, the court's holding that taxpayer properly deducted the entire amount of the discount as interest paid must be reversed.

We recognize that some part of the discount may be attributable to interest. In fact, the government admitted this at trial. Thus, it could be argued that the portion of the discount that is in the nature of interest is properly deductible. *Contra, Liberty Life Ins. Co.* v. *United States,* 594 F.2d 21, 28 (4 Cir. 1979), *petiton for cert. filed,* 47 U.S.L.W. 3814 (U.S. June 19, 1979) (No. 78-1825). This was not Liberty National's argument, however. At all stages of this proceeding it has argued that the discount was entirely and solely interest. Taxpayer refused to argue that the discount could be partitioned even after the possibility was discussed at oral argument before this panel. Because Liberty National has failed to convince us of the validity of its only argument, we must sustain the Service's determination. The judgment of the district court is therefore REVERSED.[11]

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[11] The parties have agreed that if we reach this result, there is no need to discuss the other issues decided by the district court. These other issues involved alleged deficiencies that the government asserted only as offsets against any refund taxpayer may have received if this court had decided that the discounts were properly deducted as interest paid.

APPENDIX C

United States Court of Appeals

For the Fifth Circuit

No. 77-1578

D. C. Docket No. CA 73-M-1035-S

Liberty National Life Insurance Company,
Plaintiff-Appellee,

versus

United States of America,
Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Alabama

Before THORNBERRY, GOLDBERG and GEE,
Circuit Judges.

JUDGMENT

(Filed October 1, 1979)

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in tnis cause be, and the same is hereby, reversed;

It is further ordered that the plaintiff-appellee pay to the defendant-appellant the costs on appeal, to be taxed by the Clerk of this Court.

August 13, 1979

Issued as Mandate: September 28, 1979
A true copy: (Illegible)

/s/ Brenda Hauck
September 28, 1979

APPENDIX D

In the United States Court of Appeals

For the Fifth Circuit

No. 77-1578

Liberty National Life Insurance Company,
Plaintiff-Appellee,

verses

United States of America,
Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Alabama

ON PETITION FOR REHEARING

(Filed September 20, 1979)

Before THORNBERRY, GOLDBERG, and GEE, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED

Entered for the Court:

/s/ Irving L. Goldberg
United States Circuit Judge

APPENDIX E

26 U.S.C. § 805

§ 805. Policy and other contract liability requirements.

* * *

(e) Interest paid. For purposes of this part, the interest paid for any taxable year is the sum of—

(1) Interest on indebtedness. All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) Amounts in the nature of interest. All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or

annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies. (3) Discount on prepaid premiums. All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

28 U.S.C. § 2106

§ 2106. Determination

The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside or reverse any judgment, decree, or order of a court lawfully brought before it for review, and may remand the cause and direct the entry of such appropriate judgment, decree, or order, or require such further proceedings to be had as may be just under the circumstances. (June 25, 1948, c. 646, § 1, 62 Stat. 963.)